INDIA INSIGHTS

# Minutes of the Roundtable on Stewardship Codes

November 2020

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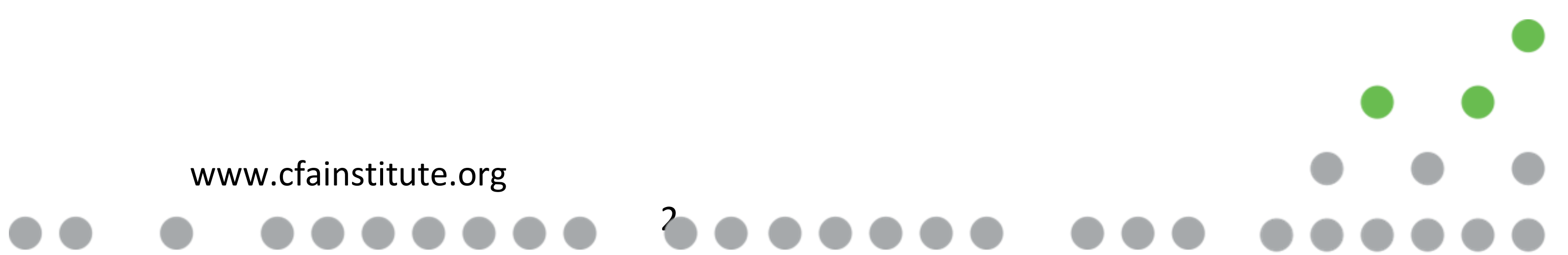

# Background

The CFA Institute convened a roundtable on stewardship codes on November 24, 2020. The roundtable was attended by C-level executives and portfolio managers of Indian mutual funds. The event started with a discussion of our Stewardship 2.0 report, followed by a keynote presentation by Guy Jubb, Vice Chair of ECGN (European Corporate Governance Network) and a renowned expert on stewardship. It was followed by a discussion where participants raised various issues related to the implementation of stewardship codes.

# Presentation of Stewardship 2.0 Report

Mary Leung, Head of Advocacy, Asia Pacific at the CFA Institute presented our research on Stewardship codes in the Asia Pacific.

The objective of stewardship is to motivate institutional investors to act as responsible owners. The single most important objective is to generate long term value for the company. The key components of stewardship codes are establishing a stewardship policy, conflicts of interest policy, monitoring and engagement of companies, disclosing voting policies, and reporting. But there are some variations in the region. The best way to think of stewardship codes is it's like the corporate governance codes which guides the behaviour of companies. Stewardship codes guide the behaviour of institutional investors.

Why is it important – the fundamental reason is value enhancement. As ESG concerns intensifies, the role of institutional investors in motivating companies to take these concerns seriously is developing rapidly. But when UK developed its code in 2010, the motivation was better risk management; The fallout of global financial crisis, and the bailouts of banking sector, a lot of investors were asking why it happened, and could institutional investors have done more.

As the concepts got transported to the region, the motivation was different – it was transparency, conflicts and interest, and governance.

In our report, we looked at institutional ecosystem. When the codes came out, it targeted asset owners and asset managers. In 2.0, the ecosystem is expanded,


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with codes being applied to service providers such as consultants, proxy advisors and data providers. The underlying concern is the misalignment between asset owners and asset managers, and between institutional investors and service providers. When asset owner or asset manager is hiring a service provider, the motivation may be cost reduction, or short-term performance, rather than the long-term value for beneficiaries. Better disclosures and expanding the ecosystem to include service providers would allow beneficiaries to assess the trade-offs.

In terms of evolution, after the first code by UK, Japan and Malaysia launched their own codes in 2014. In 2016, HK, SG, Korea, and Taiwan launched their codes. Last year SEBI launched its code. India and Australia are mandatory codes, Malaysia, Singapore, and HK were voluntary, while others are comply-or-explain, or apply-or-explain. Similarly, in terms of who administers the code, most of them are sponsored by regulatory bodies, but some are also sponsored by industry bodies and stock exchanges. We are agnostic as to who the sponsor is, if the sponsor is proactive in its implementation.

Some bodies also ask institutions to become signatories, and if the major asset owner becomes a signatory, it helps in adoption. GPIF is a signatory to the Japan code, as did Korean pension fund. A lot of people watch them as a bellwether whether the code will pick up or not.

Some of the key trends are sustainability and ESG factors are increasingly featured. Japan and UK made ESG explicit. The other concept is expanding them to other asset classes. Increasingly engagement is seen as key for other fixed income and asset classes other than equity. Stewardship codes are increasingly applied to service providers. The last one we’re seeing is the emphasis on reporting on outcomes.

In terms of CFA Institute, we prefer a comply and explain approach, since it provides a degree of flexibility. Its very important for code sponsor to continue working on it in terms of promotion and awareness. Leadership from the top is important – getting a positive signal from asset owners is important for motivating engagement from others. Inclusion of ESG is useful, and can be incorporated.

As part of the report, we did a survey; we wanted to check awareness of the codes, the effectiveness of the codes, and how they could be improved.

Across Asia Pacific (270 respondents), 42% said they've no or little understanding of stewardship codes. Japan stands out in terms of awareness (56%), Hong Kong has the highest gap in understanding.

In terms of implementation challenges, what holds the respondents back, 38% said it was the unclear link between engagement and value creation, and 36% cited the high cost of engagement as the main challenges. Clearly there is a lot of scepticism as to whether stewardship works and worth doing. We also think ownership concentration is also a factor. The rise of passive investments also makes it difficult for engagement. There are two opinions on this, and some think passive investors are becoming aggressive in terms of their engagements. In terms of impact of engagement, on economic performance, or ESG performance, most respondents said governance is where stewardship had the major impact. The typical engagement frequency is 30% (annual or no engagement), one quarter engage quarterly, and 20% engage more than quarterly. In terms of number of companies, 34% engage with less than 10% of their companies, including no companies, while 25% engage with more than half their portfolio companies.

The most popular methods of engagement where management discussions (41%), proxy voting (37%), and presentations to the management (22%).

# Guy Jubb on Stewardship Experience at Standard Life Investments

I was a fund manager with Standard life investments, and CA by background. In 1990s when we had a Cadbury committee report in UK, we recognized corporate governance was an important issue for investors. We didn't call it stewardship then, but the penny dropped, and we realized investors don't do corporate governance, they're supposed to be good stewards of funds they're entrusted with.

During financial crisis, we realized we were not holding boards to account effectively. It wasn't just governance, aspects like remuneration. IT was about getting into risk management, strategy. The work done by Sir David Walker who was asked to work on this by the government, was to recommend stewardship


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codes for investors. The great thing about a code is it provides a reference. Previously we were doing governance, but we had no reference. We realized stewardship doesn't happen by itself. In an asset management company, it needs to be planned and resourced. You need senior people engaging with companies, not just management. In UK, we're engaging with chairman and non-executive directors, these are serious people. They expect the institutions to know what they are talking about to command a degree of respect. Mary said tone from the top, I refer to it as anchors. We developed guidelines to assist us in fulfilling the responsibilities as stewards. These are not guidelines for companies, but rather us in helping evaluate companies. These guidelines were approved by the board.

I reported into the CIO, and had a dotted line into chief executive, group chief executive, and board chair. That enabled me to go and engage with companies, confident that the views that I express views. In stewardship, you've to speak truth about power. Sometimes companies would complain, and I can be confident my management would back me up. It also provided consistency as the team grew larger and got in other fund managers involved.

Each engagement we did (100s in a year), we would tailor engagement to what we wanted to get out of. The challenging thing about stewardship is the engagement process is long term, sometimes you've to chip away to achieve what you want. We've come to realize the importance of milestones. It helps understand how you're doing. Sometimes the companies aren't listening to you. The difficult decision in the integration process is whether to sell the shares because companies do not listen to you. Standard Life investments were active investors. We took large positions in companies. If we decide to sell, it was a powerful incentive to management or the board to listen.

Importance of integrating stewardship into investment process. Risk management is one. Stewardship is an excellent way to assess governance risk of companies. At standard life we used to provide health warnings to companies which had a higher risk of imploding due to governance risk. The one thing you don't want to have an investment which goes to zero, where you've locked in your losses.

In UK, much more emphasis is placed on asset manager and not just governance specialists to get involved in stewardship conversations. It's the older fund managers we found difficult to get into stewardship tent. Younger fund managers deal with it with a degree of alacrity which makes the task much easier.

Surprisingly US one of the largest capital markets in the world does not have a stewardship code in a formal sense. That said the investor stewardship group has brought together asset owners and asset managers and they have developed principles. But they lack the sponsorship that reflect a central position. It is arguably easier to get shareholder resolutions but nonetheless stewardship is less well defined and there is still a challenge in getting companies to engage with the investor groups. In Europe the codes are not uniform; there are certain countries which have taken stewardship principles seriously, like France, Netherlands, and Scandinavian countries being the primary ones, and in other parts of Europe stewardship tends to get lip service. Coincidentally just today UK government published a reported from the asset management task force and it has come up with 20 recommendations for strengthening stewardship in the United Kingdom or putting stewardship at the heart the sustainable investing.

# Panel Discussion

## 1. Balancing engagement with UPSI (Unpublished Price-Sensitive Information) / Insider Trading regulation

Qn: There is a very clear UPSI insider trading regulations, and on other hand the focus on engagement. We get very worried about where we draw the line. On one hand SEBI is telling us engagement, and on other hand they say differential access to information. There's a committee under set up under Keki Mistry. How do we reconcile the fact that if you get too much information and land in trouble?

Guy: At Standard Life Investments we face this issue as well, and we took our counsel's opinion about how we should approach it where we ended up was recognising there was a price sensitive information. I don't know if this construct is possible in India, but we created a situation where certain executives designated executives were in a position where they were able to ring fence themselves in the event you received price sensitive information. One of the challenges is in the normal course we wish to be able to buy and sell stocks and not want price sensitive information. But being a large shareholder, we would ask the company if they want to get our views on something that would be price sensitive – like an acquisition or new key executive appointments and want to make sure that we as investors were on side with what they were proposing, we would receive this information having identified this was price sensitive, the process worked that we would not have just one person in the price sensitive bubble but two people so I would always go to my chief executive who did not


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manage portfolios himself and tell him that I had price sensitive information and he and I would interact in that bubble. There are two things that you must also bear in mind – in the UK, the responsibility is to what is price sensitive lies with the judgement of the fund manager. There may be information which we had received which we judged as one, but the company may not have done so. It was very difficult sometimes to know quite when you cease to become an insider so if the company was contemplating a deal but didn't go ahead does that make you an insider? The regulators were happy with the approach.

Ans2: Public forums are available where fund managers can engage with companies say earnings calls or shareholder meetings, and insider problems does not arise. But there are cultural sensitivities, but I think those that will have to start to change. The second part is that there are occasions where we (international investors) may have strong views about certain things but we are not in a position to say this is what you should be doing, but we make our preferences known, and watch what the management does if over a period of time. If we think it hasn't changed and it's important enough that it warrants a review in terms of our position.

Qn: I've heard of instances where these it goes through the compliance route so you present your questions through your compliance and the answers also the responses also come through from the company through their compliance so there is a double filter which is applied. Does this work this way abroad?

Guy: I should have added that when the bubble was our head of compliance was part of it. They did not know very much about the information itself they may know a headline but they're very good at checking up with us if we were still in possession of my sensitive information every month or so.

## 2. Engage Versus Sell

Qn: When a company is going downhill and if you're having a large stake in it, it's like a catch 22 situation because you know if you can't exit it so quickly and you'd still need to put your best foot forward and then it will draw in the company into an engagement. But if the company doesn't improve then you need to take certain steps but by the time the price has probably fallen quite a bit so when do you take that critical decision?

In terms of taking the decision on something which you can see happening like a car crash as you say, it is difficult to offload. But companies in the UK, generally

speaking, are required to explain movements in their share price, so there is transparency which is created by way of explanation, which itself can create either stability or even an increase in the share price depending on the situation. I will come back to governance health warnings, but the real secret is trying to avoid these situations within the risk management of your portfolio. For example, if we had a corporate governance health warning on it there were certain percentages of ownership that our fund managers could not exceed without my express permission. This is where stewardship is subjective, and we didn't always get them right. There were companies which were perhaps more entrepreneurial, would have had a poor governance credentials, but nonetheless delivered excellent value; on the other hand there were others where it was perhaps a little more obvious to the stewardship professional that there was an accident waiting to happen. All said, if you’re stuck in this situation, frankly there’s very little one can do about it.

## 3. Effectiveness of Stewardship in Markets with Low Institutional Ownership

Qn – in terms of ownership, US and UK have large institutional ownership, whereas in India and most parts of APAC, its controlling shareholders. Therefore, the ability of institutions to engage and make a difference in US is higher than markets like India. The question is when you're faced with a situation where a company does something which is not in the best interest of the minority shareholders and you have an option to either oppose it or vote with your feet and exit the position. How do you decide?

Ans – It’s a fair point about controlling shareholding but in places like in the UK there is a culture around a large group of asset managers taking up stewardship. In the US the ability to get a large portion of a diversified ownership group to say no to something is also an uphill task. In markets like India, there are places where you can say no to something – in India you've got material related party transaction vote or oppose certain directorships when you've got to a certain age the thresholds become higher. You’ve some hooks in these markets and you can play each game based on the way the field is set. If you contrast this with another market in Australia which is diversified, the remuneration vote is key even though it's an advisory vote. If the company has two 25% against vote in two successive agms, it leads to a board spill so there are serious consequences of certain actions shareholders can take that can lead to a certain amount of leverage you have with management.


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## 4. Oversight and Verification of Stewardship

Qn – How do regulators audit or verify how institutional investors are implementing stewardship?

Ans: In Asia Pacific its relaxed and recommendations except for India and one code in Australia. Everything else is either voluntary or compliant or explain which means that you can do what you want. There are plus and minus in that approach. Due to various sizes and business models in the asset management industry what works for one may not work for the other and I think even for active managers typically will be engaging with a portion of their portfolio so we need to allow for that flexibility. Some are trying to collect example this practise and show the rest of the industry what can be achieved and how they can go about it so, but this is a very emerging space again. FRC is taking a proactive stance in looking at the reporting from asset managers as to not just what they've done but some of the outcomes of their engagements.

## 5. Role of Proxy Advisors Versus Inhouse Decisions

Qn – How do you consider whether to outsource decisions to proxy advisors or potentially bringing decisions inhouse.

Ans: When you are particularly managing large portfolios of global portfolios and you have lots of very small holdings in countries you are not familiar with the organisational cultural norms, it is very appropriate in that context to effectively outsource your decisions to others. As you are probably aware most voting agencies allow you to tailor their voting recommendations to your own particular preferences; there is a cost to it but it gets the job done, it keeps once clients happy, and you are able to check the box in terms of stewardship. When it comes to larger holdings or ones close to home due to sensitive issues that actually requires the fund managers to dig a little deeper then voting is enquires more intense involvement from the fund managers and governance specialists working together to come up with a solution. So, there is a role for outsourcing, but I would recommend it on a basis whereby one can always recall the outsourcing when there are important issues to address.

## 6. Stewardship and Investment Performance

Qn. Is there evidence that managers who have a well laid out stewardship policy have a better track record compared to those who do not?

Ans. At Standard Life Investments we had governance health warnings; what we used to do each year was to assign about 20-30 stocks with health warnings and we would measure the performance of those companies relative to the market, not to other managers. In general, and this is not surprising, is that in bull markets, stocks with health warning tends to outperform the index because they tended to be younger companies and managing governance was not high priority. On the other hand, when you had bear markets and a flight to quality, those companies with poor corporate governance underperform the market. Linking data to stewardship, the reason we were able to assign health warnings to companies and inform managers was because we did not just engagement but also stewardship analysis and by way of analysis, we were able to identify where the problems were and how its likely to be priced.

## 7. Engagement Threshold and Factors

Qn: What is the threshold for engagement? Or do you engage with most of the companies?

Ans: I don't know if there's a magic number but I also I think the number of markets in Asia Pacific engagement picks up from 5% onwards. According to OECD handbook on corporate governance, when you get 5% you must disclose your shareholding; you have additional rights in terms of appointing directors, in shareholder resolutions, or calling for meetings. The company is keen to engage with you. But obviously for several managers 5% in large companies is not practicable, that's why collective engagement and collective action becomes important. Otherwise I don't know there is a number that applies across the region. Passive investors like big three are increasing holdings in large portions of listed companies in several markets and I think they will engage judiciously.
Ans2: For active portfolios, it's the investment size, active weight, intended investment horizon, a combination of those determines what effort you're going to put into engaging. The other part of it is your understanding of the other side - because some management and boards are open to these, whereas others will say you can talk to us for 10 years and nothing will happen, so it comes down to a combination of that. We’ve a large active portfolio but then we also have large passive exposure which we're going to own it anyway for long period of time so we might engage.


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## 8. Sustainability and Stewardship

Qn: In you report you mentioned sustainability is becoming a prominent part of stewardship codes. This I presume means is to make your entire portfolio usually compliant accordance with on the sustainability criteria. How would you differentiate the typical ESG funds with other funds if ESG becomes an inclusive component?

Ans: When I market an ESG fund, I make implicit or explicit promises that investments are picked in a certain way and that goes beyond whether I'm engaging with said companies. Because even if I engage with these companies, they may completely equally ignore me. In terms of stewardship, one may look at the materiality of ESG issues in the investee companies make sure that they are both managing those risks as well as opportunities in a responsible way and I think that's the role of the institutional investor. Whether they select the company into the ESG fund may be a different level of consideration.
Ans2: There are 50 shades of stewardship. Full-on stewardship with some of the best practises we've been discussing, and at the other end there is voting plus, and the plus isn’t very much. One of the accidents waiting to happen is greenwashing where actually investment houses will be called out. We had with situation in the UK with a company called boohoo, a fashion store where the supply chain had some serious issues and these situations can give rise to difficulties down the road.

On the question on exclusions, its possible to include oil and gas companies in ESG funds and engage with companies and act with integrity to ensure you are driving change.

## 9. Collaboration with Other Investors

Qn: In India, are we seeing any collaboration with other investors on topic, or companies? What is the group’s experience?

Ans: Its common for international investors, but you’ve to careful about the local norms. In Japan, there is sensitivity around it. We’re collaborating with a few Indian investors.

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